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Q2 2022 Economic outlook

Into or around the storm?

A strong economy is hurtling toward dual challenges of inflation and a Fed rate hike cycle. Markets are jittery, as this combination has already caused volatility and raises the risk of a recession. We break down where there is room for the economy to moderate, and where it could outperform, and how investors can balance solid growth with rising policy uncertainties.

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A strong economy is hurtling toward two big challenges: Inflation and a Fed rate hike cycle. Markets are jittery, as this combination has already caused volatility and raises the risks of a possible recession. We break down where there is room for the economy to moderate, and where it could outperform, and how investors can balance solid growth with rising policy uncertainties.

Key takeaways

- We project economic growth of 3.0% in 2022, as business investment has room to ramp up through capital spending and inventory restocking.
- While inflation may have peaked in March, high food and energy prices will stress households and keep the Fed on a hawkish path.
- Markets have already repriced for a storm, despite solid fundamentals.

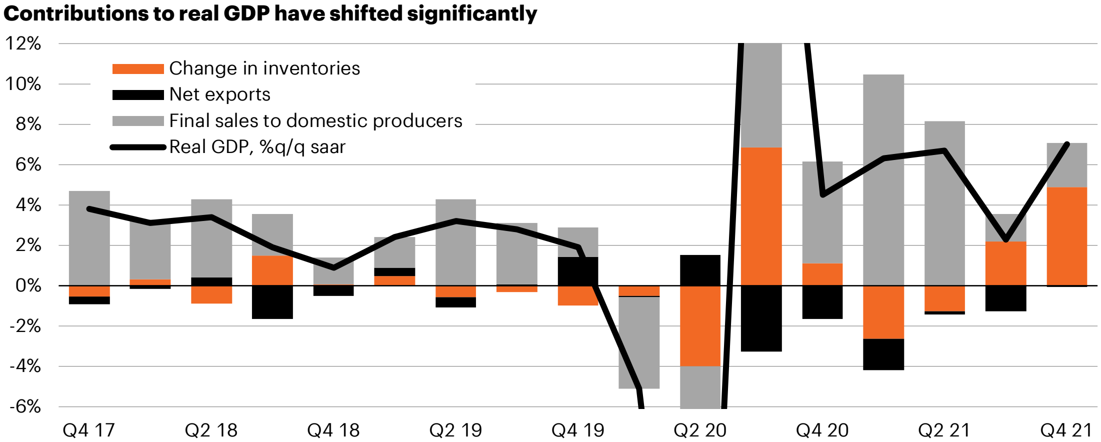
Good news: The economy has momentum and resilience

The economy is on solid footing as we enter the second quarter. The consumer balance sheet is in good shape, with leverage levels still low. Households have largely burned through their COVID-stimulus stash, and the savings rate has fallen to 6.3%. But there is room for the savings rate to fall further, and a tight labor market and rising wages add a powerful support. Corporate balance sheets are also strong, as free cash flow margins are 15%. A remarkable feature of this recovery is that corporate profits recovered quickly and are well above pre-pandemic levels.

Looking ahead at **GDP in Q2** and beyond, we expect growth to moderate. In the decade before the pandemic, our economy clocked a fairly consistent 2 1/4% real growth rate. In Q2, final sales to domestic purchasers will likely grow around 2.0%. This is roughly a combination of household consumption, business investment and government spending, which should be a net drag on growth in 2022. Households have already returned to pre-pandemic trend consumption, although the composition of spending still carries a higher weight toward goods as a full recovery in services spending remains elusive.

In 2022, we believe business spending has room to accelerate, a key reason for our 3.0% real GDP forecast for the year. We expect investment to rise as companies contend with supply-chain disruption, walk back globalization and explore capital goods investment to offset the chronic shortage of labor. Additionally, inventory levels remain severely depleted. While inventories have always been a swing factor in GDP, the magnitude of the impact has soared during the last two years.

Contributions to real GDP have shifted significantly

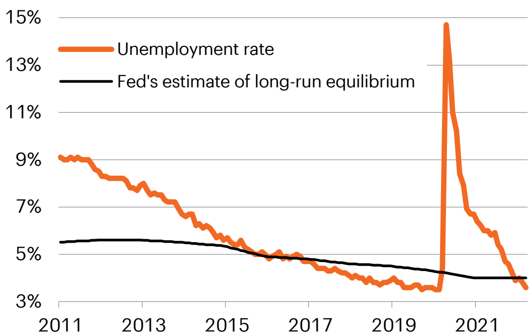


Source: Bureau of Economic Analysis, FS Investments, as of April 8, 2022.
Note: Y-axis truncated due to COVID distortions. Q2 2020 real GDP -31.2% q/q and Q3 2020 real GDP 33.8% q/q.

Real GDP rose 6.9% in Q4 of 2021, driven almost entirely by a surge in inventory rebuilding, which added 5.3% to the headline, while final sales to domestic purchasers was 1.5%. If inventories return to pre-COVID levels, there is room for a significant boost to GDP over the next four to eight quarters. Given global supply-chain uncertainties, inventories could end higher than before the pandemic.

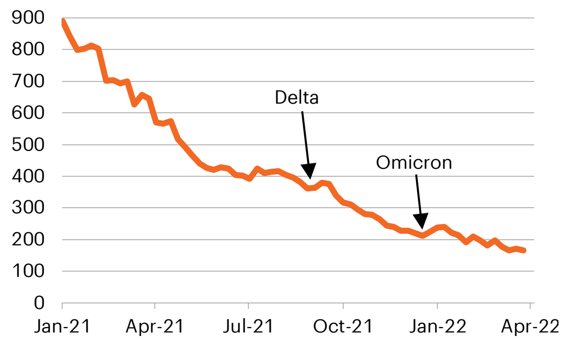
The strong labor market is a powerful support for the economy. The unemployment rate has fallen at an unprecedented pace during this recovery, and at 3.6% is close to historic lows—comfortably below the Fed's estimate of equilibrium (4.0%). We have long viewed initial jobless claims as the canary in the coal mine for the labor market, and at the end of Q1, initial claims fell to 166,000, the lowest since the 1960s.

Economy supported by a strong labor market



Source: Bureau of Labor Statistics, Federal Reserve, FS Investments, as of April 8, 2022.

Initial jobless claims show resilience



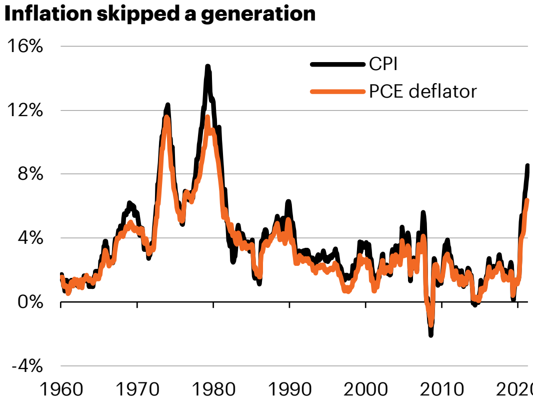
Source: Department of Labor, Bloomberg News & Johns Hopkins, as of April 8, 2022.

Critically, initial claims also indicate that our economy is showing resilience as well as positive momentum. Initial claims—and the broader labor market—barely skipped a beat as the Delta wave of COVID pushed cases up in September 2021 and when the Omicron wave hit in January of this year. The U.S. economy is now managing through COVID better than most developed countries in the world. The economy is well positioned to weather challenges in Q2 and beyond.

Inflation casts a shadow

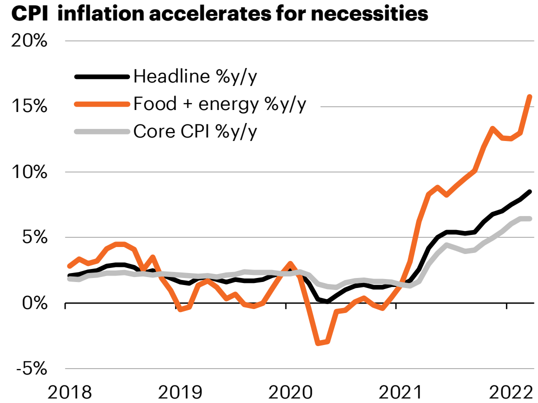
This bright outlook for growth is being clouded by **inflation**, which has erupted from virtually every sector of our economy to hit levels not seen since the early 1980s. Consumer price inflation ended Q1 up 8.5% y/y, which we think will be a peak given as base effect comparisons rotate out. We project inflation will decelerate to 4% by the end of 2022 (but see risks skewed to the upside of that number). We break down what sectors should see inflation slow, and what will keep prices stubbornly elevated.

Inflation skipped a generation



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, as of April 12, 2022.

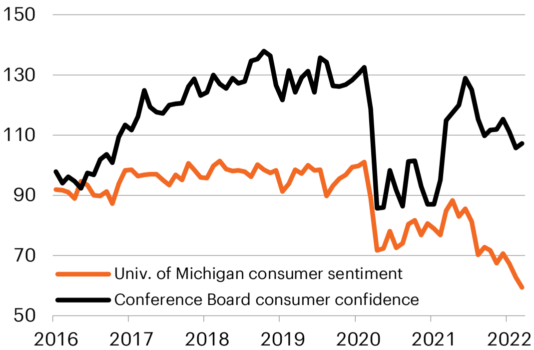
CPI inflation accelerates for necessities



Source: Bureau of Labor Statistics, FS Investments, as of April 13, 2022.

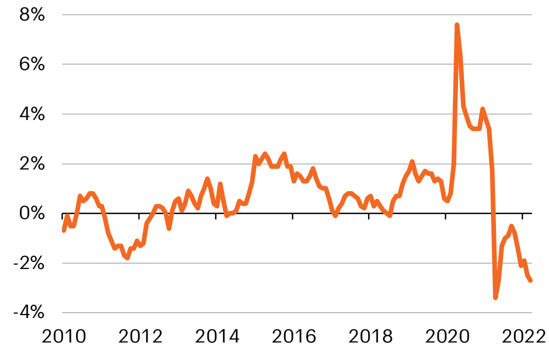
Inflation is a risk to economic growth primarily through the household. A look at combined food and energy prices—the must haves of everyone in our economy—shows a punishing surge to 15.7% y/y and is one area where prices may remain elevated well above core inflation. These higher costs for necessities can erode purchasing power for other spending and erode sentiment. Currently, the two marquee household sentiment surveys are showing remarkably different readings.

Household sentiment depends on what you ask



Source: Conference Board, Univ of Michigan, as of April 8, 2022.

Real wage growth (% y/y)



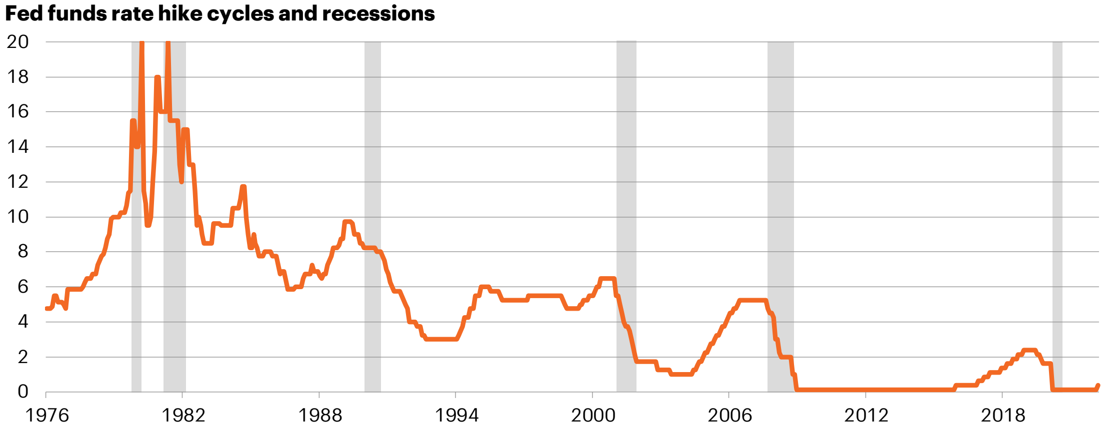
Source: Bureau of Labor Statistics, as of April 13, 2022.

The Conference Board's measure asks questions, in part related to the employment situation, and is statistically sensitive to the labor market. This index has held up rather well. But the University of Michigan consumer sentiment survey contains more questions relating to inflation, which is well below the initial low of the pandemic shutdowns. Indeed, this measure is already at levels consistent with a recession. Inflation also erodes household purchasing power through lower real wages, which have been contracting for the past year.

This Fed rate hike cycle is going to be a doozy

Our strong economy is also heading straight into what stands to be the most intense Fed rate hike cycle in decades, and markets are doing a lot of handwringing about a recession. It isn't hard to see the pattern that emerges in a long look at Fed funds rate hike cycles and inflation. At the end of a Fed rate hike cycle, more often than not, the Fed is cutting again to manage through a recession. Put simply, a "soft landing" where the Fed successfully navigates a slower economy to lower inflation while avoiding a recession is, in reality, something the Fed struggles to achieve.

Fed funds rate hike cycles and recessions



Source: Federal Reserve, NBER, as of April 8, 2022. Shaded areas represent NBER recessions.

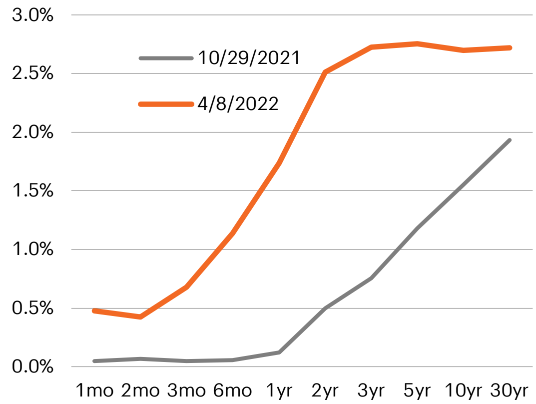
We look at what to expect from this **rate hike cycle**, which will kick into high gear in the Q2 with as much as 100 bps possible across the May 4 and June 15 meetings. The Fed will also likely begin to reduce its balance sheet as early as May, a policy tightening markets have only experienced once. This adds up to policy uncertainty beyond a normal Fed rate hike cycle.

Markets have already experienced significant volatility as Fed rate hike expectations have swung from around 25 bps of rate hikes total in 2022 to now around 210 bps, which implies at least one 50 bps rate hike at some point in 2022. But the Fed's intention with rate hikes is to slow the economy, thereby lowering inflation. We focus on **housing**, which is ground zero for rate hikes. Unlike markets that react in real time to rate hike expectations, the economy reacts to higher interest rates with a lag of four to six quarters. We explore the impact we expect this rate hike cycle to have on the housing market, and secular factors could make housing less sensitive to rates than in past cycles.

Fed funds rate expected by end 2022

Source: Bloomberg Finance, L.P., as of April 11, 2022.

Yield curves then and now

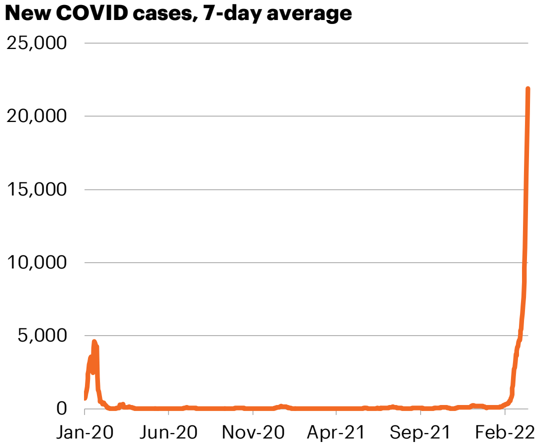


Source: Bloomberg Finance, L.P., as of April 8, 2022.

A hawkish Fed does not make a recession inevitable, but it does increase the probability of a recession sometime within the next three years. **Yield curve inversion** has already set off alarm bells because historically it is often observed one to two years before a recession. We dissect the signals coming from the yield curve and look at several other indicators that are also showing warning signs. A recession is not our forecast, but this business and market cycle are moving fast, and we are monitoring these historic recession warning signs closely.

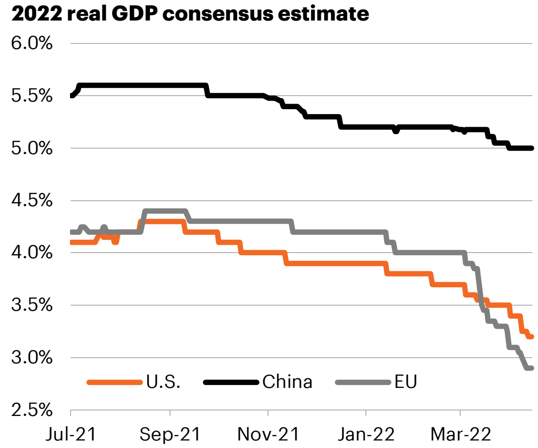
A final discussion on growth and policy focuses on **China**. China's economy was already struggling to find traction when China's zero COVID policy ran smack into the highly contagious Omicron variant, causing the most stringent and widespread lockdowns since early 2020. This is already evident in manufacturing output and consumption data, and China's stated real GDP target of 5.5% is now looking optimistic. The global flywheel of growth now seems to be slowing, as forecasts have been revised down across major developed economies.

New COVID cases, 7-day average



Source: Our World in Data, Macrobond, as of April 8, 2022.

2022 real GDP consensus estimate



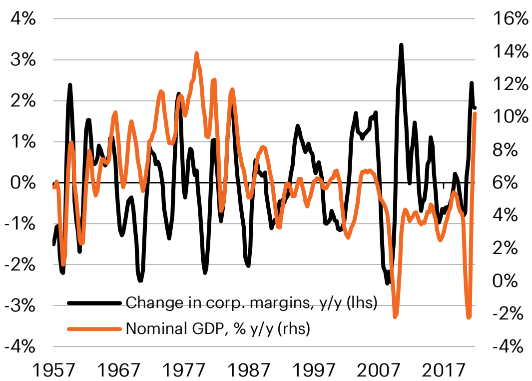
Source: Bloomberg Finance, L.P., as of April 8, 2022.

Markets have repriced for a storm

Markets had to pivot fast in early 2022. At the start of Q2, markets have priced in the most aggressive Fed rate hike cycle since the mid-1990s, quantitative tightening, surging geopolitical uncertainty, higher inflation expectations and concerns about what all of this will mean for the economy. It's a lot to digest, so it isn't surprising that volatility has ratcheted up.

For **equities**, we expect the focus to be on fundamentals in Q2. Multiple compression has been swift due to higher long-term interest rates and Fed rate hike expectations. But a strong economy and solid nominal growth mean that margins may remain well supported. While the indexes are unlikely to see valuation multiples expand, it is important to allocate to those industries with the strongest fundamentals. We explore where we see the best opportunity.

Nominal GDP growth vs changes in margins



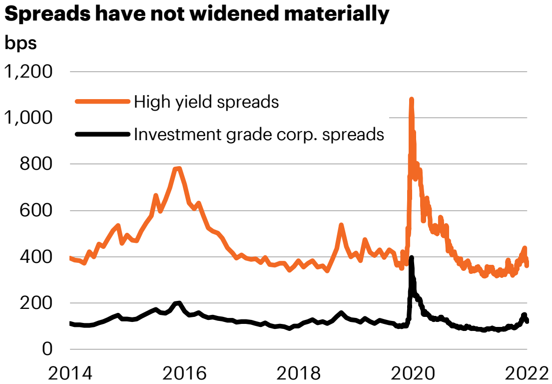
Source: Bureau of Economic Analysis, as of Dec 31, 2021.

S&P 500 fwd P/E ratio

Source: Bloomerg Finance, L.P., as of April 8, 2022.

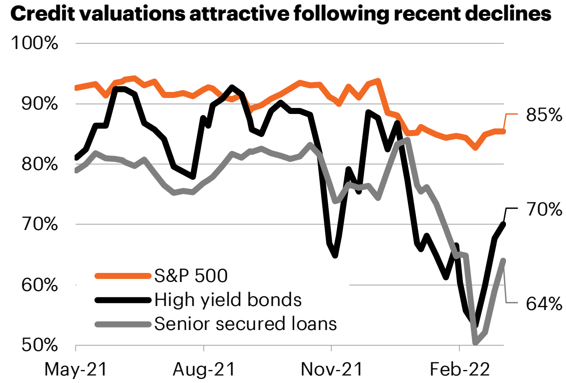
Importantly, higher inflation has raised concerns that companies will see severe margin compression as input costs rise. On the credit side, this has carried through to concerns about a wave of defaults. However, the reality is there are inflation winners and losers. Higher costs are another company's higher revenue. Historically, margins track with nominal GDP growth as a driver of fundamentals, and the outlook for nominal growth of 7%–9% in 2022 is one reason why the earnings for 2022 is 8%–10%.

Spreads have not widened materially



Source: ICE BofAML US High Yield Bond Index, ICE BofAML US Corporate Bond Index. As of March 31, 2022.

Credit valuations attractive following recent declines



Source: ICE BofAML US High Yield Bond Index, S&P 500 Index. S&P/LSTA Leveraged Loan Index. May 31, 2021-March 31, 2022.

In **credit markets**, rising rates weighed heavily on duration sensitive assets, pummeling the Bloomberg Agg with a -5.93% loss in Q1, and delivering high yield bonds their worst start to the year in history. However corporate fundamentals are solid, defaults are low and EBIDTA levels of high yield companies are 31% above their pre-pandemic peak. The second quarter will be a balancing act between credit's strong fundamental backdrop and uncertainty clouding the broader market outlook.

The economy: Momentum but moderation

Key Takeaways

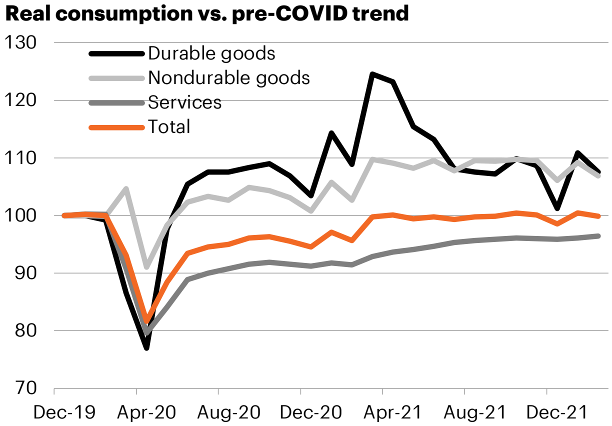
- We look for real GDP growth of 3.0% in 2022, with upside risks given inventory restocking.
- Household consumption has already returned to pre-pandemic trend growth and should drive a broader moderation in GDP toward the long-run, sustainable 2 1/4% q/q average.
- Nominal GDP—which drives corporate revenue—should rise 6%–8% in 2022.

The outlook for the economy is bright. The consumer—the main engine of growth—has a solid balance sheet with relatively low leverage and is well supported by a tight labor market. We also expect businesses to ramp up investment in 2022. While this is a smaller share of GDP, inventory rebuilding alone stands to add meaningfully to 2022 growth. All of this should all add up to growth of 3.0% in 2022.

The household has powered growth through much of the recovery, and that stands to continue. On the finance side, households have largely burned through the excess income provided by the COVID relief package. The savings rate has slipped to 6.1%, but there is room for this to go lower, which is not uncommon when the labor market is exceptionally tight. And the household balance sheet is well positioned to weather higher interest rates.

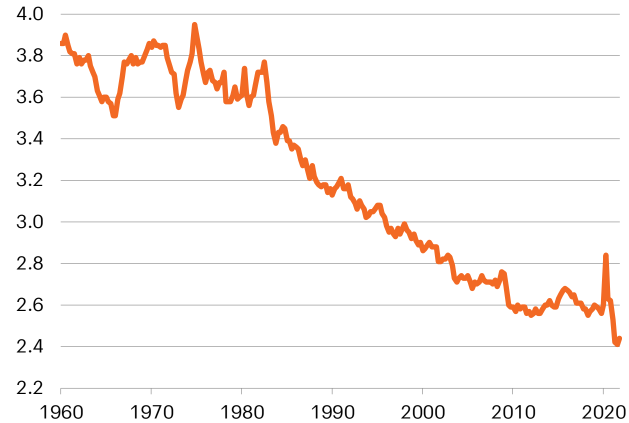
Looking ahead, household consumption has already largely returned to the pre-pandemic trend of around 2%–2.5% growth per quarter. The composition of spending remains more concentrated in goods versus services, but we don't expect much acceleration in the pace of household spending.

Real consumption vs. pre-COVID trend



Source: Bureau of Economic Analysis, FS Investments, as of April 8, 2022.
Base indexed to 100 in December 2019.

Inventory-to-sales ratio



Source: Bureau of Economic Analysis, as of April 8, 2022.

Business investment makes up less than 20% of GDP but has the potential to accelerate. Businesses spent generously on intellectual property throughout the pandemic, but capital equipment spending dropped sharply at the onset of the pandemic. Now, companies are increasingly under pressure to rethink global supply-chains and adapt to a higher cost environment where labor is scarce. During the past several decades, companies have deployed resources toward stock buybacks instead of investment.

Inventory rebuilding also stands to be a powerful source of growth in 2022. Q4 of last year gave a powerful example as inventory restocking added a whopping 5.3% to headline GDP. And even after that, inventories are severely depleted relative to the thin inventory levels that were a part of the just-in-time inventory management strategies of the prior decade. Given global supply chain uncertainty, it is likely that companies will not only want to fully rebuild inventories but also carry more inventories than they previously targeted. This process could add to real GDP growth for several years.

Moderating growth is part of the outlook. During the decade prior to the pandemic, the U.S. economy grew an average of 2 1/4% per year, and that sustainable trajectory of growth is likely where we are headed. A key difference is nominal growth. For corporate revenue, earnings and margin, nominal GDP matters more, and in 2022 we expect nominal GDP to grow 6%–8%.

Inflation: A peak without descent

Key Takeaways
- Inflation will remain elevated in Q2, but % y/y should slow as base effects kick in.
- Prices for food and energy—household necessities—could remain elevated and add to inflation-related consumer frustration.
- Used car prices are a small sub-index that has had an outsized impact and may fall in 2022.
- We expect inflation to end 2022 around 4%.

The broadly positive outlook for growth is being directly threatened by inflation. We expect consumer price inflation peaked at 8.5% in March, and while inflation will likely decelerate in 2022, our outlook is for year-end inflation of 4%, with risk to the upside. Inflation is the single biggest risk to household consumption in Q2, and even with some cooling of the year-over-year numbers, inflation will remain politically charged and will keep pressure on the Fed to act. For investors, even lower inflation will challenge nominal returns.

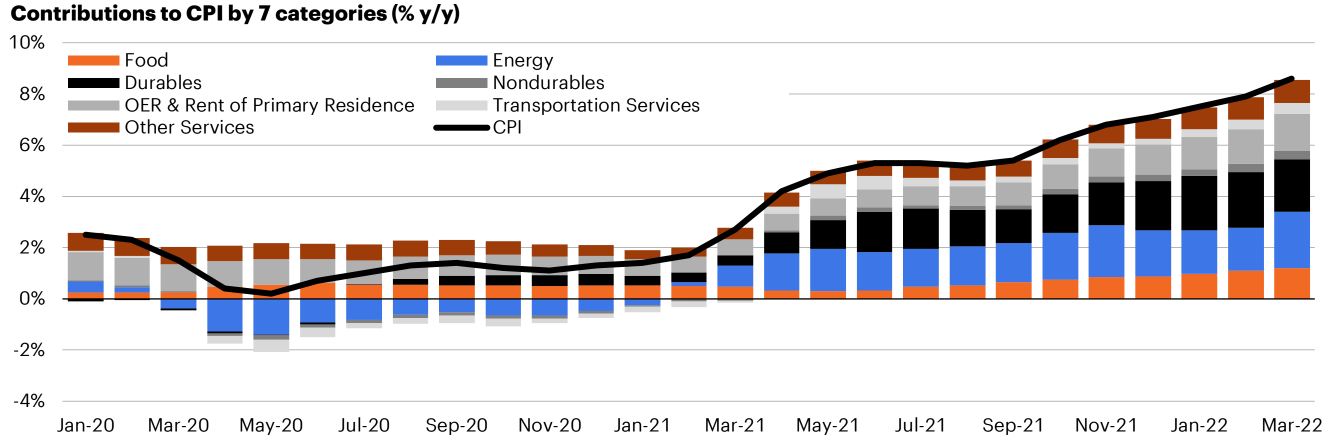
For households, rising food and energy prices have been punitive. Consumers are used to seeing volatility at the pump, but energy prices up 32% y/y have been a shock. Adding to the pain, food price inflation has simmered throughout the pandemic and has accelerated anew, hitting 8.8% in March. Given the added uncertainty in Ukraine, which has added upward pressure to the entire commodity complex, we expect these must-have components to remain elevated.

Some relief should come from auto prices, which have contributed to soaring goods price inflation. Used cars account for only 4.2% of the overall index, but inflation of over 20% y/y for most of the last year have put significant upward pressure on core inflation. Higher interest rates and gas prices may start to put a crimp in demand dynamics and used car prices are likely to moderate. In March, used car prices fell -3.8%, shaving almost two-tenths off core inflation. While used car prices are a significant factor that could exert downward pressure on the overall index, other durable goods prices remain elevated, and we see little expectation that supply-chain disruptions will relieve supply constraints.

Meanwhile, the housing market continues to fuel core inflation. Owners' equivalent rent (OER), a proxy for the monthly cost of shelter, has grown at 4.5%, the highest annual rate in 20 years. Housing prices, which usually prefigure official OER data, continue to rise. OER accounts for 23.6% of headline CPI, and we expect OER to drive broader inflation for much of 2022.

In Q2, base effects will likely bring the year-over-year calculation lower, but we project inflation to end 2022 around 4%. Geopolitical uncertainty and continued lockdowns in China would suggest upside risk to our outlook. This is far above the Fed's 2% target, which is also the average 2% regime that prevailed for decades. Food and energy prices will likely be higher than 4%, and risk eroding consumer confidence and household spending. Investors will likely still have to contend with negative real interest rates as inflation outpaces what we expect to be a modest rise in long-run yields in 2022.

Contributions to CPI by 7 categories (% y/y)



Source: Bureau of Labor Statistics, FS Investments, asof April 12, 2022. Note on categories: Energy, food, owners' equivalent rent and transportation services categories are all represented by their CPI defined subindices. Other categories combine subindices and apply CPI designated weights. Durable goods: Household furnishings, recreation, education & communication, transportation. Non-durable goods: Apparel, medical goods, alcoholic beverages, other goods. Other Services: Lodging away from home, tenants' & household insurance, water & sewer collection, household operations, medical care services, recreation services, education & communication, other personal services. Categories are meant for illustrative purposes.

Fed policy: This one's gonna be a doozy

Key Takeaways

- The Fed is expected to raise rates as much as 100 bps over the next two meetings in Q2.
- In the wake of the Fed's sharp, hawkish pivot, markets are already pricing in rate cuts, which can be interpreted as a "hard landing."
- Quantitative tightening is also expected to begin in May, adding to policy uncertainty.

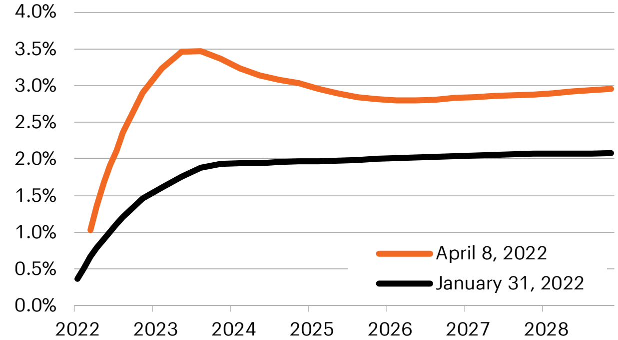
In Q2, the Fed is expected to follow its March rate hike with as much as 100 bps of rate increases, making it the fastest start to a rate hike cycle since the early 1980s. Markets expect the Fed funds rate to end 2022 at over 2.50% if it all goes according to plan. If that weren't enough, in Q2 the Fed will also start shrinking its balance sheet to reinforce its removal of policy accommodation to cool the economy and fight inflation. This rate hike cycle is shaping up to be a doozy.

This frenzied pace of policy tightening reflects the fact that the Fed is badly behind the curve on its mandate to keep inflation stable around 2%. Fed Chair Powell recently gave significant airtime to the notion that the strong economy can weather rate hikes, allowing the Fed to avoid a recession. And yet, the risks for the economy and markets have ratcheted up significantly as the Fed has made clear it will move aggressively.

A look at prior Fed rate hikes cycles shows how hard it is to orchestrate a soft landing. In all but two instances, rate hike cycles since the 1970s have resulted in a recession within the next two years (often sooner) and necessitated rate cuts rapidly on the heels of the final rate hike in the cycle. The 1994–1995 rate hike cycle did not result in a recession but saw a financial market crisis where the Fed had to intervene in markets and cut rates within five months of the last hike.

This time around, markets are bracing for the same. As the Fed has rapidly turned more hawkish, markets have become convinced that policymakers will overshoot and be required to reverse course and cut rates. In January, markets were looking for just five rate hikes total in 2022 and priced in no further Fed action thereafter. Now, markets are pricing in eight to nine rate hikes spread over the remaining seven meetings in 2022, with the Fed funds peaking in mid-2023, quickly followed by rate cuts in 2024.

Markets bracing for a hard landing

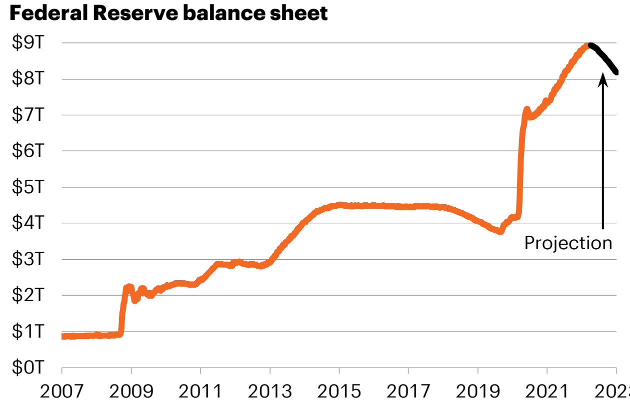


Source: Bloomberg Finance, L.P., as of April 8, 2022. Long-run Fed rate expectations are represented by 3-month eurodollar futures curve.

Quantitative tightening (QT) also looms as a policy uncertainty—and potential challenge—for markets. In May, the Fed plans to quickly begin to ramp up QT and soon allow $60 billion of Treasury assets and $35 billion of mortgage-backed securities (MBS) to run off each month. This is almost twice as fast as the run-off rate of prior QT. (As last time, the Fed does not initially plan to sell securities, but instead rely on run-offs.)

Because so many reserves are currently held in the Fed's own repo facilities, the Fed's expectation is that significant reduction can be accomplished without causing a liquidity crunch in financial markets. But volatility in benchmark interest rates rise has already increased significantly and stands to reverberate more significantly to broader markets. Unlike quantitative easing—which has become a staple of the Fed's toolkit over the last 15 years—QT has only been attempted once, and in 2019 ended with an explosion of volatility that caused a fast reversal. QT adds to the probability that the Fed's aggressive policy tightening will overshoot.

Federal Reserve balance sheet



Source: Federal Reserve, as of April 11, 2022.
Projection based on guidance given in March 16, 2022 FOMC minutes.

Housing: Ground zero for rate hikes

Key Takeaways
- The housing market is ground zero for rate hikes' impact on the economy.
- Affordability has already been impacted.
- Secular factors could make housing less sensitive to rates than in past cycles.

The Fed is raising rates to address inflation, but unlike markets that react in real time to shifting rate hike expectations, the economy reacts to higher rates with a lag of four to six quarters. Housing is among the most interest rates sensitive sectors of the economy. Higher yields have already materially impacted the cost of financing, pushing the 30-year mortgage rate above 5% for the first time since 2011.[1] While this has sapped affordability and threatens to slow the white-hot market, there are reasons to believe housing will not be as sensitive to higher rates as in the past.

Over the past two years, housing has been a microcosm for the pandemic-era economy. Voracious demand, combined with limited supply, materials shortages and tight labor have driven up home prices 31% since March 2020. Home sales have soared above pre-COVID levels, and the inventory of existing homes has dwindled to 1.7 months, a record low. The key concern is if buyers resist eye-popping mortgage payments, home price growth could slow materially, affecting both household balance sheets and construction.[1]

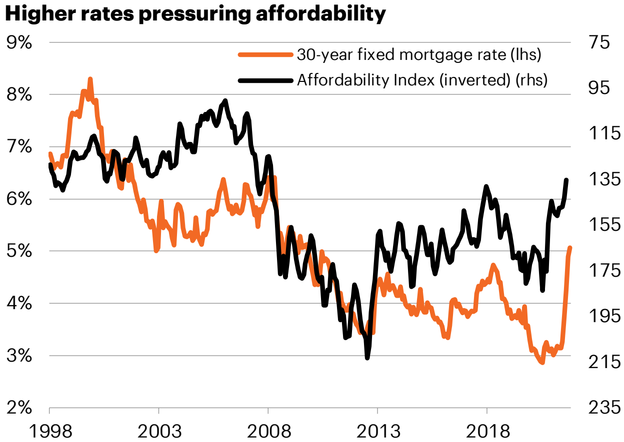
Construction spending on single-family housing has been frenzied since the onset of the pandemic as homebuilders looked to capitalize on high prices.

However, as with many areas of the economy, materials and labor shortages have pinched the industry. While the 106,000 new homes for sale are a 14-year high, the number of completed homes for sale is at a multi-decade low. Builders have struggled to complete homes, further pressuring the availability of inventory to satisfy demand.[1]

There are early signs that higher mortgage rates are causing buyers to hesitate. Purchase mortgage applications have fallen sharply in the past two months and refinancings, a source of funds on the margin for households, have dried up. The level of existing home sales, while still elevated, has declined roughly 9% since the January 2021 peak. And buyer sentiment is, predictably, low—63% say now is a bad time to buy, the highest since the early 1980s.[1]

However, we believe secular factors complicate the backdrop. The massive millennial cohort has entered the market, driving demand for starter homes. Their parents, the Baby Boomers, hold significant wealth and remain active at the upper end of the market. The trend toward remote work has increased regional mobility and enhanced the value that consumers put on their living space. Certainly a 25% increase in the average mortgage payment will likely cool the market. Still, the spike in housing demand appears secular, and builders cannot make up for a decade of underbuilding in one or two years, especially considering shortages. If demand remains solid, prices may hold up, reassuring homeowners and keeping construction spending (which feeds to GDP) running strong.[1]

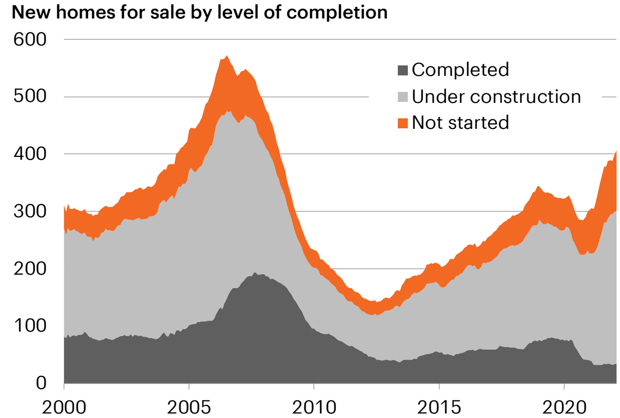
Higher rates pressuring affordability



Source: NAR, Bankrate.com, as of April 8, 2022.

Supply remains scarce

New homes for sale by level of completion



Source: U.S. Census Bureau, as of February 28, 2022.

1 Bloomberg Finance, L.P., as of April 8, 2022.

Yield curve inversion and other tea leaves

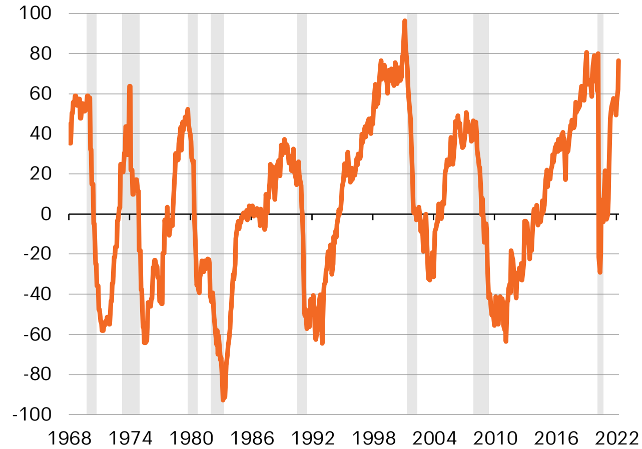
Key Takeaways
- Fleeting yield curve inversion set off alarm bells about a possible recession (with good reason).
- Multiple indicators point to the accelerated pace of the current policy and business cycle.
- While we don't forecast a recession, risks have risen of a contraction in the next two to three years.

Yield curve inversion has set off alarm bells at the start of Q2, and for good reason. Historically periods of yield curve inversion—here we focus on the 2-year to 10-year Treasury yield spread—have preceded recessions.

Yield curve inversion as a predictor of recession is often met with skepticism for the simple reason there is no reason in and of itself why an inverted yield curve would cause a recession. It is a conundrum that prior to the 2020 recession, the yield curve was inverted. It is unlikely the yield curve was predicting a global pandemic. And yet, the regularity with which yield curve inversion precedes recessions makes it important to acknowledge that with the Fed aggressively tightening policy, the risk of a recession in the next three years is rising.

There are other warning signs. Household consumption accounts for 70% of GDP, meaning household spending makes the difference between growth moderation or recession. In the past, the difference between two household sentiment indicators has been a noteworthy indicator of recession. Households are very optimistic about the present, but increasingly pessimistic about the future, causing this difference to jump higher.

Consumer confidence ratio



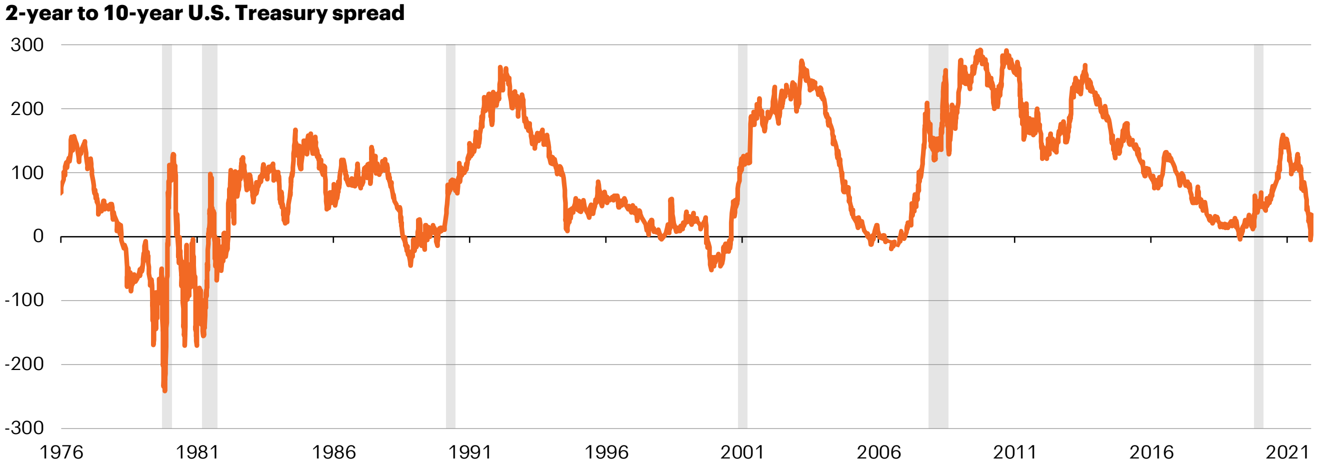
Source: The Conference Board, NBER, FS Investments. Ratio represents present situations less expectations. Shaded areas represent NBER recessions. As of April 8, 2022.

For households, concern about the future often then drags confidence lower, causing spending to be curtailed or delayed.

Finally, the current unemployment rate of 3.6% is well below the Fed's 4.0% estimate of full employment. This is also a statistically important indicator in quantitative models that predict the odds of a recession over the next three years.

For now, the Fed has only raised rates one time in March. It may feel premature already to be discussing a possible recession given that growth is expected to be well above potential in 2022. Yet the COVID recession, recovery and subsequent policy reactions have been on fast-forward compared with the long and slow recovery of the prior two business cycles. Our expectation is that this business and market cycle continues to move fast, and we will be monito ring these and other warning signs closely.

2-year to 10-year U.S. Treasury spread



Source: Macrobond, NBER, as of April 8, 2022. Shaded areas represent NBER dated recessions.

China: A long road through COVID

Key Takeaways

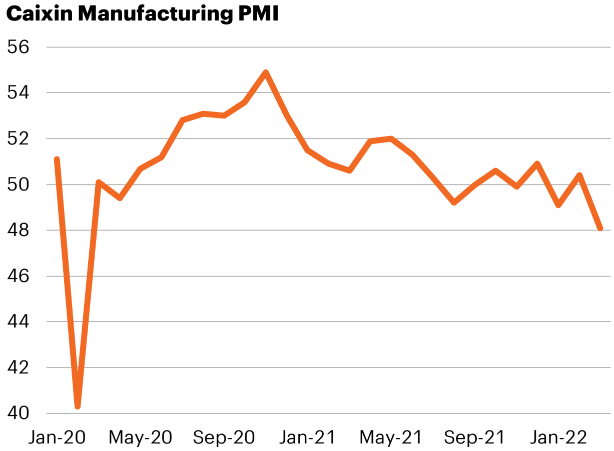
- China's 5.5% GDP projection for 2022 now appears only optimistic.
- In Q2, China's economic growth will be interlinked with its handling of the pandemic.
- Monetary and fiscal policy have turned stimulative, in contrast with other developed countries, which are tightening.

China began 2022 with hopes that stimulative policy would foster a solid growth rebound. But China struggled to gain economic traction in Q1 and is now facing the additional significant challenges from COVID-19. In Q2, whether China can effectively manage lockdowns without crippling their economy will be a focus. The zero COVID policy is being tested, and the road to economic growth will interlinked with handling the pandemic.

China's stated growth target for 2022 is 5.5%, which is arguably optimistic given the first quarter. China's stringent pandemic response, which has caused broad citywide or regional shutdowns when just a few cases are found, has been a headwind for the household consumption since the pandemic began. Now, as the Omicron virus tears through Shanghai, the China's zero COVID policy increasingly looks too costly, and unsustainable. And yet, it may remain in place for the rest of the year.

The impact on the economy is already apparent and will likely worsen in April. The Caixin Manufacturing Index hit 48.1 in March, the lowest since February 2020. The NBS manufacturing PMI hit a five-month low in March, with declines in the production and demand indices.

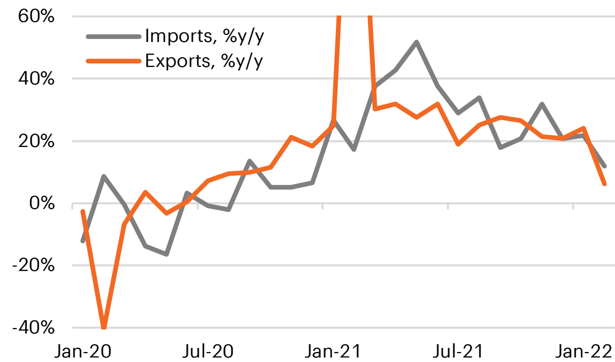
Caixin Manufacturing PMI



Source: Macrobond, IHS Markit, as of March 31, 2022.

Outside of COVID, China's property woes of last year have continued, and house prices have been falling since Q3 of 2021. This creates another headwind to consumption, as homes comprise a huge portion of Chinese household wealth.

Exports fade as a source of growth

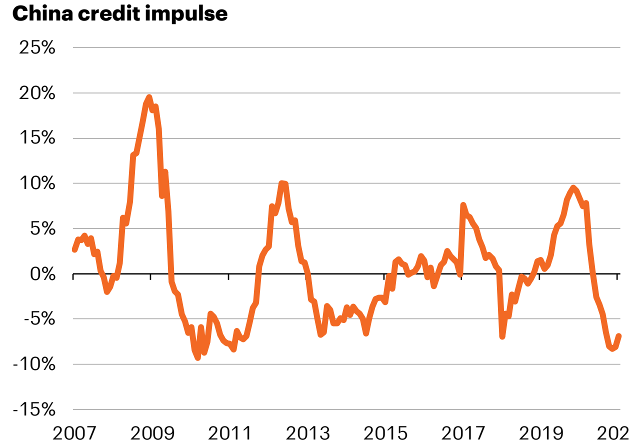


Source: Marcrobond, China Customs Statistics Information Center, as of February 28, 2022. Export growth was 155% in February 2021.

Finally, exports provided a powerful source of growth in 2021 but have begun to decelerate. This could continue as growth in the U.S. and Europe moderates while higher commodity prices will keep import prices elevated, likely lowering China's trade surplus in 2022. Combined with the crackdown on property speculation, this leaves infrastructure spending as the likely driver of growth this year.

Monetary policy has turned stimulative, and there is room for more, but the scope may be modest. Fiscal stimulus will also add support, focused on the housing market and manufacturing. However, we expect China to miss its growth target for 2022. Ultimately, China will have to choose between Common Prosperity and zero COVID.

China credit impulse



Source: Bloomberg Finance L.P., as of March 31, 2022.

Equities: Fundamentals in focus

Key Takeaways

- Equity markets declined to start 2021 as higher risks and rates drove down multiples.
- The outlook for earnings remains solid.
- Sector and regional dispersion in fundamentals are profound.

Q1 marked the first quarterly decline for U.S. equities since Q1 2020 as the S&P 500 fell -4.60%. The combination of worsening inflation, the associated aggressive response from central banks and the outbreak of war in Ukraine weighed on risk sentiment and valuations multiples. Value stocks beat growth by 1,700 bps during the quarter, second-most in the past 20 years as rising rates forced a sharp rotation. Valuations are unlikely to become a tailwind any time soon, leaving earnings as the decisive factor for equity performance.

Last quarter saw remarkable dispersion between sectors driven by a dislocation in the commodities complex and an 83 bps increase in the 10-year Treasury yield. Energy stocks returned 39% as oil and gas prices soared. Cyclicals were mixed, with commodity-sensitive industries leading and consumer-focused industries lagging. Technology stocks, especially high-multiple software names, were among the worst performers, with the Nasdaq 100 declining -8.91%.

Stocks enter Q2 in an environment unlike any in recent memory. The war in Ukraine has injected more uncertainty into the inflation situation as companies scramble to retain all-time high profit margins. Interest rates are on the rise as the Fed contemplates balance sheet wind down and appears set to hike their policy rate by 50 bps at their May meeting.

To us, the only certainty right now is that dispersion, both regional and on a sector basis, will continue to be profound.

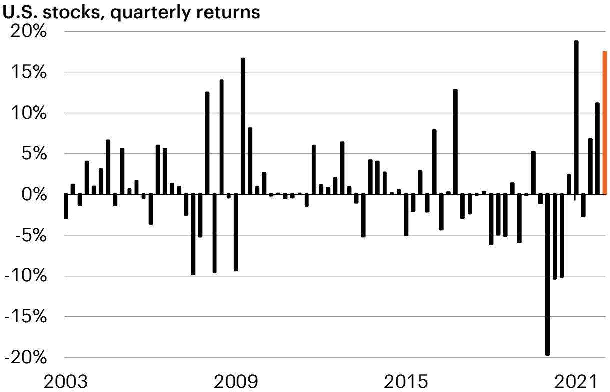
Inflation is the great divider for fundamentals, a theme that can be seen plainly in our chart below. The dispersion of changes in operating margin by industry is incredible—as of Q4, it was more than 9%. When we dig deeper, we can see the industries that have seen the largest margin expansion are energy, transportation, materials, and semiconductors—mostly suppliers. The laggards were utilities, retailers, construction and food—mostly those exposed to higher input costs.

In our view, inflation alone is not enough to drive down S&P 500 margins (and thus earnings). One company's higher cost is another's revenue. The ultimate question will be the impact of inflation and higher interest rates on economic growth. Sharply higher energy and food prices, along with the COVID outbreak in Asia, have undoubtedly raised the chances of a global economic slowdown, though that is not our base case. Our view continues to be that earnings, expected to grow between 5%–10% in 2022, can remain strong despite headwinds.

The environment for risky assets has become more challenging. Risks abound, and indexes are unlikely to see valuation multiples expand materially. Thus, the importance of allocating to those industries with the best fundamentals has risen. We continue to see suppliers such as semiconductors, materials and industrials as among the most attractive sectors right now.

Relative performance, Value vs Growth

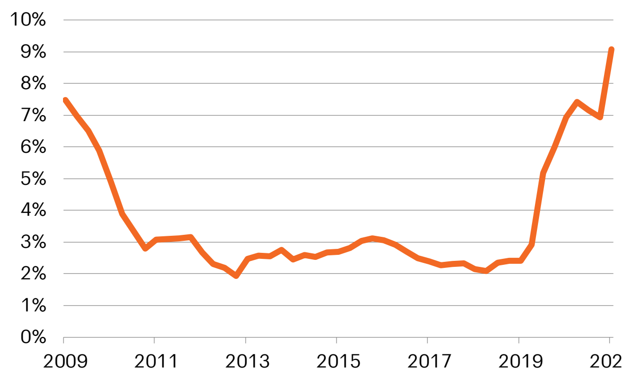
U.S. stocks, quarterly returns



Source: Bloomberg Factor Performance, as of March 31, 2022.

Dispersion of S&P 500 industry margin changes

Disperison of % y/y margin changes; trailing 4-quarter m.a.



Source: Bloomberg Intelligence, as of December 31, 2021.

Credit markets: A balancing act in Q2

Key Takeaways

- Sharply rising rates weighed heavily on duration sensitive assets, with the Bloomberg Agg's Q1 decline eclipsing its worst annual lost on record.
- The highest rated high yield bonds declined more than lower rated credit in response to rising rates.
- Credit fundamentals remain extremely strong, but macro level risks are growing and may continue to weigh on the market.

Sharply rising interest rates have whipsawed markets this year, with duration-sensitive assets suffering acutely. The Bloomberg Agg lost -5.93% in Q1, eclipsing the core fixed income proxy's worst annual lost on record, and investment grade corporate bonds were down -7.74%.

The stability and consistency that characterized sub investment grade credit markets for much of 2021 quickly evaporated. Despite strong fundamentals, the turning of the calendar ushered in a regime of volatility and growing uncertainties. High yield bonds lost -4.51%, the market's worst start to a year in history. Decomposing returns show the rising interest rates that weighed heavily on core fixed income markets also took a toll on high yield bonds.

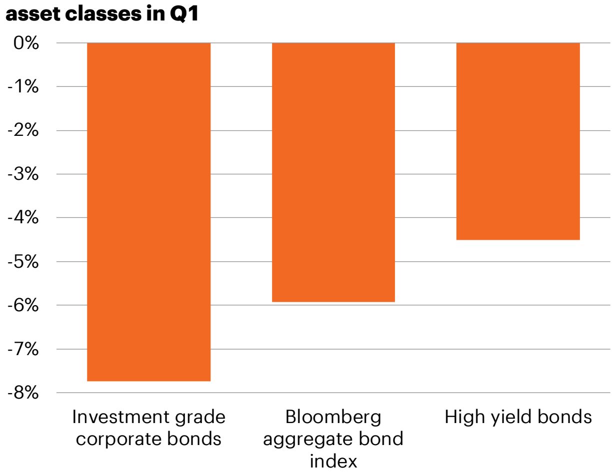
Typically, in declining market environments like this, we'd expect to see lower-rated assets such as CCC bonds underperform higher-rated Bs and BBs. This makes sense intuitively: During volatile periods, investors prefer the relative safety of higher-rated credits.

The performance witnessed in Q1, however, did not match this trend. BBs declined -5.37%, drastically underperforming CCCs, which lost -3.72%, suggesting credit markets were largely trading in response to rising interest rates and not fundamental credit risk. As the highest-rated HY bonds, BBs carry the lowest yield and have historically had the greatest duration sensitivity. Plus, a large swath of the BB universe is comprised of recently fallen angels—which, as previously investment grade rated bonds, tend to also trade in reaction to interest rates.

Where does this leave credit going forward? Historically, HY bonds have been resilient in the face of rising rates, posting positive returns in the ensuing months. However, we acknowledge that should interest rates continue to rise in the sharp manner we've seen, high yield bonds, especially in the higher-rated portions of the market, could continue to suffer. If the interest rate picture begins to stabilize, we think credit is still positioned well, given its strong fundamental backdrop. Revenue and EBITDA grew at a record pace last year, now having surpassed pre-COVID peaks. The recent declines, especially in this highest-rated high yield cohort, may have created opportunities to purchase some of the strongest issuers from a fundamental perspective at compelling prices.

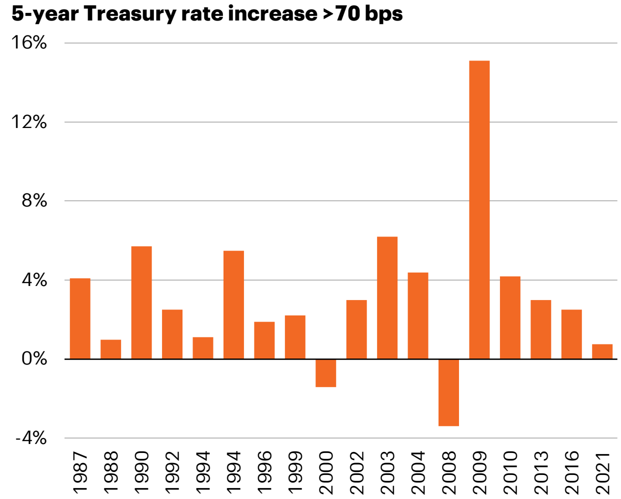
Still, we acknowledge that markets face a growing list of uncertainties, which could continue to cause volatility going forward. The second quarter will be a balancing act between credit's strong fundamental backdrop and the growing market risks.

Rising rates weighed heavily on fixed income asset classes in Q1



Source: Bloomberg Finance LP. ICE BofAML US Corporate Index, ICE BofAML US High Yield Index, Bloomberg Aggregate Bond Index. As of March 31, 2022.

3-month fwd high yield bond returns following 5-year Treasury rate increase >70 bps



Source: JP Morgan, FS Investments.